RITTMANN

Capital Management

Q2 2014 Commentary

Note to Clients:

The Dow and the S&P 500 reached new highs during the quarter. Easy monetary policies from the Federal Reserve, years of rock-bottom interest rates and rebounding corporate profits have been major underpinnings of the rally. But the latest surge toward 17,000 has come as the Fed has been pulling back on its bond-market purchases, a feat few thought the Fed could pull off without knocking the rally off course.

Instead, the Fed has been delicate and deliberate about its message of keeping rates low and staying accommodative even as the economy continues to improve. That has created an environment where stocks continue to look attractive as the bull market, running for over five years, keeps chugging along. Investors spent the better part of five years fixated on central-bank policy, thanks to the Fed pinning interest rates near zero and three rounds of quantitative easing. That has changed now.

Toward the end of the quarter, a rash of unsettling events shattered the relative calm of the U.S. stock market and put investors on edge. We saw a spike in oil prices and increased market volatility as geopolitical developments dominated the headlines, though their influence on stocks seems fairly contained. Not even a miserable first-quarter reading on GDP could stop the rally. The revised Q1 2014 GDP reading that the economy shrank by 2.9 % was horrible, even suggesting recessionary pressure on the economic recovery. The most severe winter since 1960 affected everything from consumer confidence, to consumer spending and productivity. But many look past the numbers since it was somewhat isolated to January and believe that the setback is temporary with growth rebounding solidly since Spring.

The market calm is a stark contrast to the “taper tantrum” that occurred roughly this time last year, when stocks slumped and emerging-market currencies tanked at the mere prospect of the Fed pulling back on its accommodative policies. Over the past five years, markets have hung onto every phrase, word, even hint from the Fed. From QE to the taper tantrum to chatter of rate increases, the Fed for years has been a prominent driver of both day-to-day moves as well as long-term trajectories across markets. Investors and strategists say they have started focusing more on traditional market catalysts, like corporate profits and economic growth. The transition to fundamentals and away from the Fed has been much smoother than many previously anticipated.

On the domestic front, the employment picture has improved. We have seen two consecutive job reports showing unemployment rate of 6.3%, compared with 6.7% in April, so the employment trend seems to be getting better. However, we are seeing stagnant wage growth and stagnant household income growth. There is also an alarming rate of labor non-participation as a bulge of baby boomers are retiring at a rapid pace. We currently have the lowest labor participation rate since 1978. The demographic change we are seeing is that as more workers leave the workforce, it is making those who are employed to have to work that much harder. Over 10,000 baby boomers are retiring each day and that is depressing the market. Also, many youth (under 25 years old) are not entering the workforce. The largest decline in the labor/workforce participation rate has been those under 25 years old, not a good trend.

Unfortunately, the housing market's loss of momentum seem more than just a transient weather related occurrence, as limited supply and declining affordability are restraining activity. Slowing housing sales since July were a major concern for the economic recovery. Another challenge is flat wage growth has also restrained buyers. But late in the quarter, the May housing figures were above expectations and we hope to see that trend continue.

A favorable trend we see is an uptick in capital spending, or "capex". Over the past several years, corporations have used cash to buy back stock and/or issue dividends. We call this financial engineering. But stock buy backs and issuing dividends has lost some luster as interest rates have moved slightly higher and equity valuations make borrowing to finance buybacks less attractive. Hopefully, we will see some of this cash used for capex. Such spending on areas of information technology, the building out of infrastructure for the shale revolution, and increased construction spending for the housing recovery may help drive market momentum forward.

Tech trends we want to be associated with are centered on companies that provide disruptive technologies. Those companies who have the greatest pace of innovation and disruption are those we want to own. It is in cloud computing, it's in data, it's in mobile, all at one time….trends that are here now and will only get bigger. The fundamentals of these companies are changing at a more rapid rate than those of large-cap companies in non-tech areas. Greater change translates into faster growth, which means valuations should continue to expand. Looking past the broader valuation correction we have seen early in the quarter in the higher-growth cloud software market, we think some of our companies deserve the highest premiums in the market.

One mega-tech trend we are following is the adoption and proliferation of internet-connected "machines" and/or "devices". Cisco has coined the phrase "Internet of Everything" in that machine-to-machine and machine-to-person communication will have an impact on every aspect of our lives and the economy. It increases our productivity by bringing people, processes, data and things together. We are now in a phase where more and more aspects of our life are connected to the internet (apart from smartphones, e.g. wearables such as shoes, watches, wireless cardiac monitors or home appliances and cars) and this will only increase exponentially over the next few years. The environment of total connectivity will reshape the way people work, interact, consume or learn, simultaneously improving productivity, accessibility and visibility. As a result, the vast amounts of data will help companies gain a better understanding of consumer behavior and desires, making them more in tune with customer needs.

The energy renaissance in the United States is still in the early innings, and it is also translating into the manufacturing sector. A great example can be seen in Louisiana. Some 66 industrial plants, worth some $90 billion – will be breaking ground over the next five years. Sasol, a large South African oil company, is building a huge gas to diesel plant, and to quote the CEO, “if you are going to build a plant, from a logistical standpoint it is No. 1 in the world. Access to cheap natural gas, customers, capital, rule of law and ease of building, it ticks off all the boxes very nicely. It could not have happened to a better country”. We are definitely moving in the right directions, as large multi-national companies have many choices where to do business, and to choose the U.S.A is a huge win.

The market is expecting better economic data. Many investors are waiting until they see proof that the economy is accelerating to buy stocks.

We don’t see any of the ingredients that we would usually see to suggest a boom-bust scenario for the economy. Inflation is low, the Fed is very accommodative, and we are about to accelerate in terms of growth in the U.S. and around the globe slowly. An improving economy should lead to better corporate earnings, which should translate into higher equity prices over the next 6 to 12 months. So this is a nice economic backdrop for investing.